BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI.

POINT I.

A taxpayer can ignore the separate entity of its subsidiary corporation where it is a mere instrumentality with no substance of its own.

Smithfield, the subsidiary corporation in the instant case, is a mere instrumentality or department of its parent, Esmond. Its tax return for 1937 (R. 50) which is part of the stipulation of facts, shows that it did not pay salaries to officers nor salaries or wages to employees, and did not pay rent. Its only expenses were taxes, accounting fees and miscellaneous items. Its only source of income was commissions made on the transfer of goods to its parent, Esmond, at cost. Its inventories were not used in determining income since it made no income from the purchase and sale of merchandise. Its balance sheets at the beginning and end of the year show that it was financially unsound and unable to make the payment of $31,636.19 without Esmond's help. It was a mere hollow shell, without substance, and completely dependent on and under the domination and control of Esmond.

Since the decision of this Court in the case of *United States* v. *Lehigh Valley Railroad Co.,* 220 U. S. 257, there has been a well established rule that the separate corporate entity of a subsidiary corporation will be ignored where it is a mere instrumentality of

the parent corporation. This case was cited favorably in *United States* v. *Reading Co.,* 253 U. S. 26, and the *ratio decidendi* further explained as follows (p. 62): "yet where such ownership of stock is resorted to not for the purpose of participating in the affairs of the corporation in which it is held in a manner normal and usual with stockholders, but for the purpose of making it a mere agent or instrumentality or department of another company, the courts will look through the forms to the realities of the relation between the companies as if the corporate agency did not exist and will deal with them as the justice of the case may require." And this rule of law has been carried over into tax cases, *New Colonial Ice Co.* v. *Helvering,* 292 U. S. 435; *Southern Pacific Co.* v. *Lowe,* 247 U. S. 330; *Gulf Oil Corp.* v. *Lewellyn,* 248 U. S. 71. In the *Southern Pacific* case the court held that dividends which otherwise would be taxable are exempt from taxes since they were received from a subsidiary corporation which was merely a part of its parent, "acting merely as its agent, and subject in all things to its proper direction and control".

While this rule of law is a well established one and has never been questioned, it is only an exception to the general rule that a corporation's separate entity will not be ignored, and is limited to cases where fraud or injustice would otherwise result or where a corporation is used as a mere department or instrumentality of another.

However, since the decision of this Court in the case of *Higgins* v. *Smith,* 308 U. S. 473, decided January 8, 1940, the Government has contended that the precedent established in the *Southern Pacific Co.* case, *supra,* and similar cases has been overruled and re-

placed by a broad rule that in tax cases the Government has the option of relying on or ignoring the separate entity of a wholly-owned corporation. This contention was made in the case of *U. S.* v. *Brager Building & Land Corp.*, 124 F. (2d) 349 (Circuit Court of Appeals, Fourth Circuit), in the following language quoted by the court from the Government's brief: "The general rule appears to be that the corporate entity may be disregarded by the government in furtherance of the collection of proper taxes, but may not be disregarded by its creator to reduce tax liability." The court, however, rejected this contention, saying: "But it is going too far to say that if a taxpayer forms a corporation for his convenience, he is thereafter estopped from disclosing the true nature of the arrangement whenever it is of advantage to the government to recognize only the corporate form. The advantage of the taxpayer has been served by many decisions in which the identity of the corporation and its sole stockholder has been adjudicated, and we do not understand that this body of the law has now for practical purposes ceased to exist." To the same effect are the cases of *North Jersey Title Insurance Co.* v. *Comm.*, 84 F. (2d) 898 (3rd Circuit) and *Inland Development Co.* v. *Comm.*, 120 F. (2d) 986 (10th Circuit).

These decisions are in conflict with the decisions of the Fifth and Eighth Circuit Courts of Appeals in the cases of *Comm.* v. *Moline Properties, Inc.*, 131 F. (2d) 388 and *Interstate Transit Lines* v. *Comm.*, 130 F. (2d) 136, respectively, but these two cases have been brought up for review by this Court by writs of certiorari granted March 8, 1943, their docket numbers being 660 and 552 respectively.

In view of the fact that the issue in the instant case on the recognition of the separate corporate entity of a wholly-owned corporation is identical with the ones in these cases brought up for review, and since the Circuit Court of Appeals in the instant case based its decision on the rule of the *Interstate Transit Lines* case, it is submitted that this case should be brought up for review by this Court together with these two cases already before the court.

POINT II.

The advances made by Esmond to Smithfield to reinstate its inventory depreciation and to cancel its unfavorable purchase contracts were deductible either as ordinary and necessary business expenses or as losses.

Under the practice established between Esmond and Smithfield (R. 41), when stocks of cotton and wool were transferred to Esmond, Smithfield was credited with the cost thereof plus commissions. Therefore, all inventory losses were absorbed by Esmond, and its losses were not the indirect ones sustained by any corporate stockholder when his corporation incurs a loss, but a direct merchandising one arising from its course of dealings with Smithfield.

But even if the lower court were correct in holding the loss on inventory depreciation to be non-deductible, it was patently wrong in holding the payment of $31,636.19 for the cancellation of Smithfield's unfavorable purchase contracts to be non-deductible. The course of dealings between the two corporations effected the loss caused by declining markets to fall on Esmond, and it had the right to minimize these

losses, and to deduct the amounts expended therefor, irrespective of the corporate relationship between Smithfield and Esmond.

A case in point is *Helvering* v. *Community Bond & Mortgage Corp.*, 74 F. (2d) 727 (Circuit Court of Appeals, Second Circuit). In that case, a real estate corporation had employed another to be its exclusive selling agent for the sale of its stock. Discovering that this agent was acting in such a way as to impair its business reputation, it purchased the capital stock of this corporation and thereupon cancelled the exclusive selling agency, and deducted the purchase price of this stock as a loss on its tax return for that year. The Circuit Court of Appeals sustained this deduction, saying: "It is not an unusual occurrence of business for a business enterprise, burdened with an unprofitable contract, to secure its cancellation by payment of money, and it is difficult to see why an expense thus incurred is not an 'ordinary and necessary expense according to the ways of conduct and the forms of speech prevailing in the business world'. *Welch* v. *Helvering*, 290 U. S. 111, 54 S. Ct. 8, 9, 78 L. Ed. 212." Similarly, in the instant case, Esmond, because of the declining markets prevailing in 1937 (R. 41), and its commitment to take over Smithfield's inventories at cost, was faced with merchandising losses which were steadily increasing. It therefore had the right to minimize these and the sums expended in so doing were properly deductible under the doctrine of the above cited case. The case of *Seufert Bros. Co.* v. *Lucas*, 44 F. (2d) 528 (Circuit Court of Appeals, Ninth Circuit), is similar to the *Community Bond & Mortgage Corp.* case, *supra*. There, a payment made to alter the location of a new

highway so as not to damage the taxpayer's property (which the highway as originally planned would have done) was held to be a deductible loss, and the principle enunciated that payments made to avoid larger losses were deductible as losses. This decision also is in conflict with the decision of the lower court in the instant case.

CONCLUSION.

In view of the conflict of the decision of the Court below with various decisions of this Court and the other Circuits, and because this Court has already agreed to review the questions of the estoppel of a taxpayer to deny the existence of its own "dummy" corporation and of the Government's right to rely on or ignore the existence of a corporate entity, this petition for a writ of certiorari should be granted.

Respectfully submitted,

Andrew B. Trudgian,
Counsel for Petitioners.